Tests for a Monopoly

Three Tests
- Performance
- Rivalry
- Structure

Performance
- How does the firm's actual performance deviate from the competitive norm?
  - How much does price depart from marginal cost?
  - How much does its profit margin exceed that of a comparable competitive industry?

Performance
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  - How much does price depart from marginal cost?

Measuring MC is hard

Performance
- Accounting vs. Economic Profits
  - Acme Widgets has a very high debt load. Baker Widgets does not. Acme will have a lower accounting profit margin than Baker. But this does not imply that Baker is monopolistic, only that it has a different capitalization policy.
Performance

• Accounting vs. Economic Profits
• Intangibles
  – Berkley Photo has few intangibles such as patents, etc. Kodak Company has a valuable brand name. Its higher profit margins are attributable to its ownership of a valuable factor of production, not to monopoly power.

Performance

• Accounting vs. Economic Profits
• Intangibles
  – High profit margins are generally a return on historical investments in the pharmaceutical industry. They are evidence of monopoly power from patents and trademarks, permissible under the Rule of Reason.

Rivalry

• In a perfectly competitive environment, a firm looks only a price. In a monopolistic environment, price elasticities will matter.
• How do firms change in response to buyer behavior?
• How do firms change behavior in response to changes in a rival’s sales and prices?

Elasticity

• Three estimates of the price elasticity of demand for Acme Widgets faces have been published: (a) -0.67, (b) -1.5, and (c) -10.0.
  – The first looks like a screwed up estimate
  – The second might be a monopoly
  – The third looks like a competitive firm.

Elasticity

• Acme Widgets cuts output and is able to raise price.

Rivalry
Tests for a Monopoly

Rivalry

• Acme Widgets cuts output and is able to raise price.

A competitive firm is a price taker.

If you see price going up, you will see output rising as well.

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Rivalry

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MC
Rivalry

• The prices of Acme Widgets and Baker Widgets seem to be set like duopolies. While hard to prove this could constitute clear evidence of a cartel.

Summary

While valid tests, they are difficult to prove and use in practice.

Structure

• Does the firm actually have a large market share?
  – A firm with a large market share is considered to be a monopoly: one with a small market share is not.

Measuring Market Share

\[
Share = \frac{Sales}{Sales + Substitutes}
\]

What is a Substitute

• Substitutes for Coca-Cola
  – Pepsi?

What is a Substitute

• Substitutes for Coca-Cola
  – Pepsi?
  – Other Carbonated Beverages?
What is a Substitute

• Substitutes for Coca-Cola
  – Pepsi?
  – Other Carbonated Beverages?
  – Tea?
  – Coffee?
  – Milk?

• Substitutes for Coca-Cola
  – Pepsi?
  – Other Carbonated Beverages?
  – Tea?
  – Coffee?
  – Milk?
  – Water?

• More to come

End

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